



October 15, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals¹ that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies"). While I favor capital requirements which will help to ensure our industry is properly capitalized to weather future economic events, the current proposals are overly complicated and fall disproportionately on community banks.

I am writing as the Executive Vice President and Chief Financial Officer of Capital City Bank Group, Inc. ("Capital City"), a 117 year old, \$2.5 billion one-bank holding company

¹ The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

headquartered in Tallahassee, Florida. We operate sixty-six offices in north Florida and south Georgia and are the very essence of a community bank in that we gather deposits from our local communities and reinvest those same dollars by lending them to consumers in these very same markets. We do not originate subprime mortgages, have proprietary trading portfolios or deal in derivatives, yet we have been adversely impacted by the onslaught of regulation which has been implemented in recent years, and our ability to serve our communities will be further damaged by the implementation of the proposed Basel III regulations.

Although Capital City operates in Florida and Georgia – two of the hardest hit states in the recent economic downturn, we have managed to maintain our capital base. In fact, our risk-based capital ratios have actually improved over the last four and one half years. However, if we apply the proposed rules in their fully phased in version as of June 30, 2012, it results in a 490 basis point reduction in our total risk based capital ratio reducing it from 15.5% to 10.6%, which is only .1% above the *proposed* “well-capitalized” level of 10.5%. While Capital City would continue to be designated as “well-capitalized,” it significantly reduces our flexibility and ability to lend money and to expand our business either organically or through acquisition.

While there are many aspects of the Basel III regulations, as a community banker there are two very specific elements that are of grave concern – the elimination of Trust Preferred Securities (“TPS”) from regulatory capital and the inclusion of Other Comprehensive Income (“OCI”) in the calculation of the our regulatory capital. These concerns are addressed below.

Trust Preferred Securities – In 2004 and 2005, we used the issuance of TPS to partially fund two separate acquisitions with the full assurance that these instruments would be counted as Tier I capital for regulatory purposes. As of June 30, 2012, we have \$62 million in TPS outstanding which represents 23% of our total regulatory capital. To now be told some eight years later that this capital will be phased out over a ten year period is not equitable. Through the Collins Amendment, the Dodd-Frank Act (“DFA”) grandfathered TPS for community banks, so why should Basel III now override DFA? Capital City is a publically traded bank holding company, but with only 17 million shares outstanding and 31,000 shares in average daily trading volume, our access to the public markets is limited, particularly when compared to the regional and mega banks. Therefore, it will be difficult to replace this expiring source of capital and, if we were to be successful in obtaining new capital, it will in all probability result in dilution to our existing shareowners. Consider further the challenge for privately held community banks, which essentially have no access to the capital markets.

While I can appreciate restricting the inclusion in regulatory capital of newly issued trust preferred securities on a go-forward basis, what purpose is served by changing the rules

mid-stream for those community banks which have issued trust preferred securities for legitimate business purposes in the past?

Inclusion of Other Comprehensive Income in the Calculation of Regulatory Capital – As of June 30, 2012, Capital City had \$24 million in Other Comprehensive Income (“OCI”) consisting of \$0.6 million in an unrealized gain on our “available for sale” securities portfolio and \$24.6 million in an unfunded pension liability associated with Capital City’s defined benefit plan, resulting in a net reduction of our book capital of \$24.0 million.

Unrealized Gains/Losses – Interest rates are at their historical lows and there could not be a more disadvantageous and dangerous time to enact regulations requiring the inclusion of unrealized gains/losses in the calculation of regulatory capital. While many regulators suggest most banks in this country will continue to be “well-capitalized” under the Basel III regulations there has been very little work done to analyze the impact on the capital of our industry when interest rates return (which they will) to more normalized levels. It should also be noted that when rates move off of their lows and begin to return to historical norms, they generally do so in a rapidly accelerating manner, leaving little time for banks to adjust their capital levels.

Given the current economic environment, bank loan portfolios are not growing and, in most cases, the portfolios are declining. At the same time, banks are flush with deposits and therefore are carrying significant liquidity on the balance sheet – this is especially true for community banks. Capital City is selling \$300 million to \$400 million into the overnight market on a daily basis, which represents 12% to 15% of total assets, a historically high level. In an effort to protect net interest margins, community banks are deploying this excess liquidity into the securities portfolio. As a result, banks’ securities portfolios are elevated relative to historical norms. Not only does this increase the potential adverse impact on a bank’s capital as interest rates rise, but inclusion of unrealized gains/losses in regulatory capital increases the volatility as interest rates rise and fall in the future. In practice, community banks generally hold investment securities to maturity, therefore this induced volatility is unnecessary and inconsistent with a community bank’s business model.

Another fallacy in recognizing unrealized gains/losses in the calculation of regulatory capital is that it selectively includes one category of the balance sheet (i.e. “available for sale” securities) while ignoring all other categories. In a rising rate environment, the value of a bank’s core deposit base increases significantly and would more than offset the losses incurred in the available for sale securities portfolio, yet the fair value of the bank’s core deposit base is not accounted for in OCI. Again, an inconsistency which further damages a bank’s capital and this is particularly true for community banks,

which have limited access to more sophisticated products and broader markets in which to make investments. As a result, a large percentage of their excess liquidity is invested in the “available for sale” securities portfolio, which is one of the few asset classes marked to market through OCI.

Unfunded Pension Liability – From an actuarial perspective, our defined pension plan is funded at 127%, however, due to accounting concepts/conventions we have an unfunded pension liability of \$24.6 million (net of taxes) recorded in OCI. In contrast to the actuarial calculation, the unfunded liability for accounting purposes under ASC 715 is created by the fact that we have to project out our obligations, including raises, for our associate base, yet it assumes no further cash contributions to the plan. While I understand the accounting and the rationale for recording the liability from this perspective, to now suggest this unfunded liability must be deducted from regulatory capital is nonsensical as the plan is more than fully funded on an actuarial basis.

Just these two elements (TPS and OCI) of Basel III, collectively, have the potential to reduce our total risk based capital by \$86 million, or 33%. This obviously does not account for the other elements which must be deducted from capital and the higher risk weightings to be applied to various asset classes; all of which will further diminish our regulatory capital levels.

As of June 30, 2012, Capital City had \$96 million in risk based capital over and above the minimum required (10%) to be designated as “well-capitalized”. Full application of the Basel III rules will reduce our excess capital from \$96 million to \$1 million. Depending on the business cycle, a community bank will lend \$6.00 to \$8.00 for each dollar in capital. For discussion purposes, let’s assume an average of \$7.00. As noted above, application of the new capital rules will reduce Capital City’s excess capital by \$95 million and, therefore, will reduce our capacity to extend credit by \$665 million, which will further impact the economic viability of our communities at a time when our communities need access to credit and the federal government is challenging banks to lend. If you then apply this analysis to the over seven thousand community banks nationwide, you can begin to understand the aggregate impact it can have on the availability of credit as well as pricing.

This letter is not intended to be an exhaustive discussion of the recently issued proposals, but a real life application of Basel III and its adverse impact on a community bank. These proposals are at cross purposes with the federal government’s desire for banks to make more credit available to support economic growth. Further, the proposals disproportionately penalize community banks and, if left in their current form, will result in a forced consolidation of community banks due to their limited access to capital markets.

Your full consideration of these comments is greatly appreciated and I will be happy to discuss in greater detail at your convenience.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "J. Kimbrough Davis". The signature is stylized with large loops and a long horizontal stroke extending to the right. It is positioned over the printed name and title of the signatory.

J. Kimbrough Davis
Executive Vice President

CC: Senator Marco Rubio
Senator Bill Nelson
Representative Steve Southerland
Wayne Abernathy – American Bankers Association
Alex Sanchez – Florida Bankers Association

